15 October 1981

1981 JEC BRIEFING POINTS

I. **State of the Economy** - As the Soviet Union completes the first year of its new five-year plan, the economy has turned sour before the much discussed labor and energy problems have become acute.

GRAPHIC I:

Soviet GNP Growth

-- GNP growth, which averaged 4% annually during 1971-78, fell to 1% in 1979-80.

-- Only weak rebound expected this year; our 1981 GNP forecast is for less than 2 1/2% growth.

-- Agriculture is headed for another bad year; a grain crop of only 170 million tons expected; because of record grain imports the past two years, however, meat production will not fall.

-- Industrial growth continues to slow; output grew only 2% in first-half 1981 compared with first half 1980; second worst showing in post-war period.

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A. The shortfalls in the economy have advanced the time in which the leadership has to deal with the impending economic crunch.

-- investment will not be enough to sustain high rates of growth in view of poor productivity trends of recent years.

-- Several critical sectors such as energy, transportation, agriculture will need greatly increased investment, but planned annual increase in investment of 2 1/2% per year during 1981-85 is even less than the 3 1/2% achieved in 1976-80.

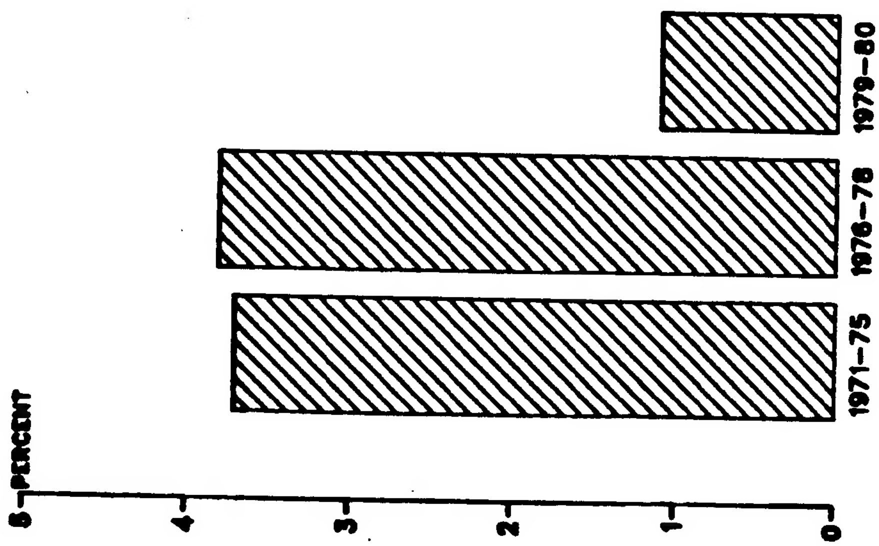
-- US defense spending plans have also probably led the Soviet military to ask for more money.

-- The chaos in Poland has shown Moscow how expensive maintaining power in Eastern Europe might become.

B. Against this background, we would like to discuss four aspects of Soviet policy that are critical to the economic vitality of the USSR and of great importance to East-West relations.

FIGURE 1

USSR: AVERAGE ANNUAL RATE OF GNP GROWTH
1971–80



-- recent developments in agriculture and energy

-- use of foreign trade as a means around their domestic difficulties

-- possibility that the Soviets might modify their military programs in response to changes in US defense programs or to give more resources to the civilian economy.

II. <u>**Agriculture**</u> - farm output in 1981, while about 1 1/2% more than in 1980, will still be below the 1976 level.

GRAPHIC II:

Soviet Farm Output

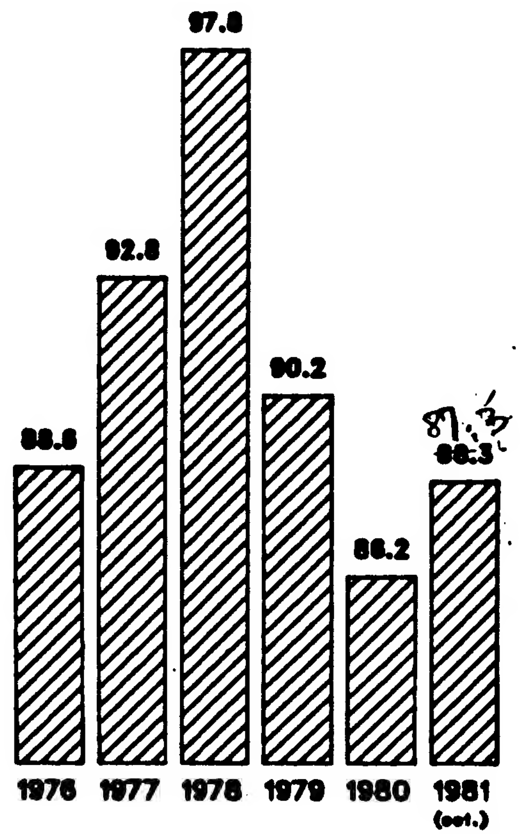
-- Soviets are counting on a change in the weather and have been relying on massive imports as stop-gap measure.

-- Net imports of farm products have nearly doubled since 1978 and are expected to rise by about 1/3 in 1981.

-- The leadership, given the current resource bind, has not increased the share of investment

FIGURE 2

USSR: VALUE OF FARM OUTPUT
(billion 1970 rubles)



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going to this sector since mid 1970s. Current FYP suggests no change in this strategy in 81-85.

A. The restrained attitude of leadership reflects not only the belief that weather conditions will improve but that widespread popular unrest is unlikely.

-- Moscow has increased special distribution systems so that elite groups and factory workers get first crack at food supplies

-- blackmarket activities have reduced some of the pressure by assuring that those with sufficient funds and access get something extra

B. The leadership may be too complacent in its attitudes

-- even with continuing large imports and return to average grain crops, only small increase in per capita consumption likely

-- productivity will suffer

-- alcoholism will probably continue to increase; already see rise in mortality rates in part because of heavier drinking

-- getting the hard currency to support massive imports of food and other consumer goods will be far more difficult in 1980s.

III. **Energy Problems** - also becoming more severe. Growth slowing sharply at a time when costs soaring.

GRAPHIC III:

USSR: Projected Energy Growth

-- Total energy output in million b/d equivalent will grow only about 2% per year in 1980s compared to 4.5 per year in 1970s.

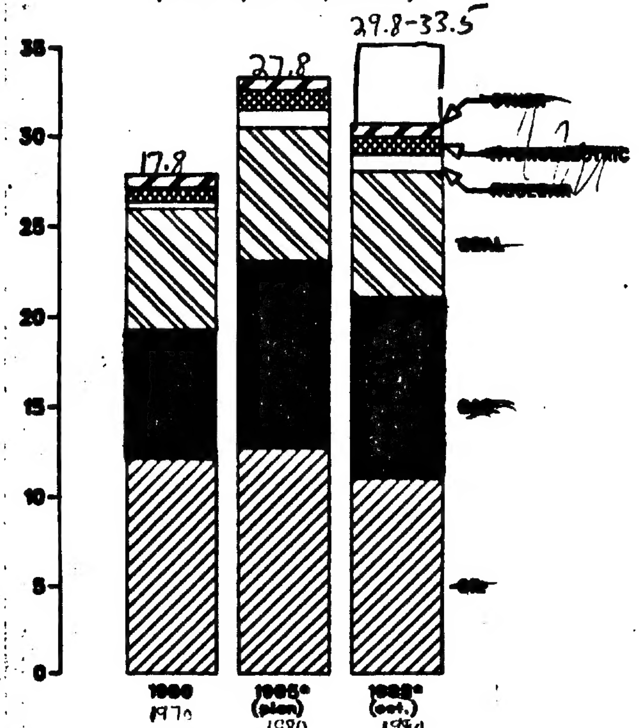
A. Oil is the major Soviet energy problem.

-- Our 1977 forecast remains essentially valid.

-- We do not believe Soviet plans, which call for oil production to grow at 1% per year through 1985, are feasible. Our current forecast is 10-12 million b/d by 1985. We expect a further decline in the second half

Fig. 4

USSR: PRIMARY ENERGY PRODUCTION
(million b/d oil equivalent)



* Midpoint of range.

of the decade.

-- The fundamental problem is that the Soviets have been depleting their reserves, especially their high quality reserves, more rapidly than they have been found.

-- Most serious is the declining quality of reserves. New production is coming from smaller fields or less productive strata. Consequently, the amount of drilling needed per unit of oil output is increasing rapidly.

-- Although the increased use of Western equipment could help delay the decline temporarily, it would also steepen it when it comes. ?

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B. Oil is not the only energy problem.

-- Coal output has declined from a high of 724 million m.t. in 1978 to probably only 710 million m.t. this year.

-- Despite large reserves, output will probably be no higher than 740 million m.t.

by 1985--far short of the 770-800 m.t. target.

C. Gas remains the one big Soviet hope for the future.

-- By 1985, production of 10 million b/d in oil equivalent expected, about one-third more than currently.

-- The Soviets will have to tie-up enormous investment resources to meet this target.

-- must build an unprecedented 6 major trunklines, each one a larger undertaking than the Alaskan oil pipeline. In current terms you're speaking around roughly $10 billion to build an Alaskan pipeline.

-- Conservation is not the answer.

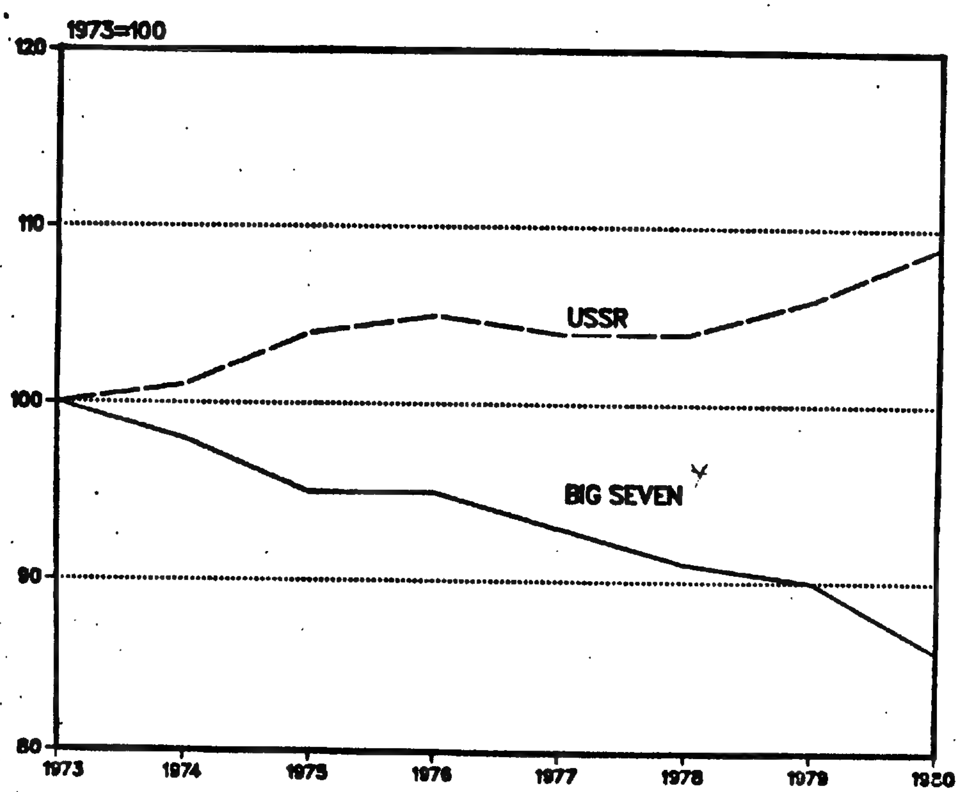
GRAPHIC IV:

USSR-West Conservation Comparison

-- Unlike the West, Soviet energy consumption has continued to grow more rapidly than GNP.

Fig 4.

ENERGY/GNP RATIOS



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GRAPHIC V:

USSR-West Energy Use

-- less energy consumed in transportation and residential areas where major gains have been made in the West

-- conversion of industrial and power facilities is extremely costly and in any case could not be done before the end of the decade.

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IV. **Hard Currency Problems** - Because of a strong hard currency position during the past two years --caused largely by a favorable shift in terms of trade--Moscow has been able to turn to the foreign sector for relief from its domestic problems. Hard currency earnings from energy, gold and arms sales reached $30 billion in 1980.

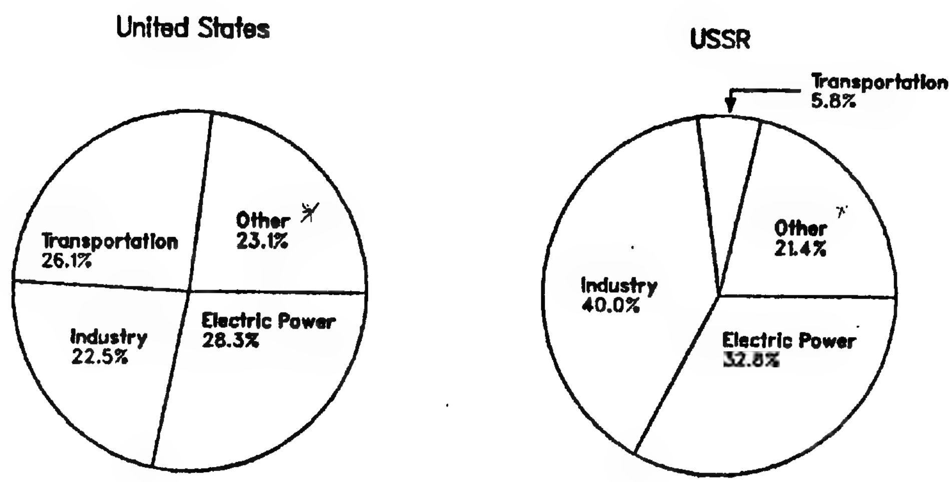
These earnings helped finance

-- agricultural imports to prevent a deterioration in the Soviet diet.

-- Imported steel to offset domestic production shortcomings.

Figure

UNITED STATES AND USSR: GROSS ENERGY CONSUMPTION, 1975



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-- Purchases of equipment and tubular steel pipe from foreign suppliers, which allowed stepped-up investment and exploitation of critical energy resources.

A. This year, however, Moscow's trade position has taken a turn for the worse.

-- The Soviet trade deficit could double to at least $5 billion as another poor harvest pushes up agricultural imports and soft world demand cuts earnings from oil sales.

GRAPHIC VI:

USSR: Hard Currency Chart

-- This year Moscow's total food bill could reach almost $12.5 billion, or over 40 percent of Moscow's hard currency imports.

B. Despite the developments in the trade account, we expect Moscow to close out 1981 with a current account surplus, albeit one much reduced from the 1980 level.

-- Earnings from services, arms exports, and gold sales should more than offset the $5

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Figure ~~9~~

USSR: Hard Currency Imports [a]

	1976	1977	1978	1979	1980	1981 [b]
Total hard currency imports *(billion US $)*	14.8	13.7	16.6	21.2	26.2	29-30
Agricultural imports *(billion US $)*	4.1	3.2	3.8	5.5	8.8	12.5
Agriculture's share of the total *(percent)*	27.7	23.4	22.9	25.9	33.6	41.7-43.1

[a] Current prices.
[b] Estimated.

billion trade deficit and the higher interest payments on foreign debt.

C. If the trade trends evident since 1979 continue, however, the USSR could find itself in a hard currency bind within a few years.

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-- The export picture is not bright for Soviet products. Oil export earnings will be squeezed by stagnant or falling production, rising domestic consumption and probably weak prices.

-- The Siberian gas pipeline--the only potential large earner of foreign exchange --could not be fully operational until 1986 or 1987 at the earliest.

-- Some potential may exist for increasing aim sales--last year Moscow added $14 billion in new military contracts to its order books.

-- But the export picture is not bright for other Soviet products.

D. Thus, in the near term, Moscow will have to rely more on gold sales and on Western borrowing, if it is to avoid the unpleasant task of cutting agricultural products or capital goods.

V. **Defense** - Is defense a way out of their domestic problems? Will we see an even more rapid growth in defense spending to match new US programs, or will it continue to grow at its historic rate of 4-5%?

A. All current evidence points to defense continuing to grow at its historical rate of 4-5%. The evidence includes weapons production and testing underway, as well as programs currently on the drawing board. Given the country's economic problems, this means fewer resources for investment and consumer welfare.

B. If the Soviets opted to reduce the growth of defense budget, some bottlenecks might be eased but basic economic problems would remain.

GRAPHIC VII:

USSR: Military-Civilian Trade-Offs

-- a number of military programs preempt high quality resources that could be used in civilian economy (e.g. military ships and ground forces armaments use combinations of materials needed by industries producing pumps, machine tools and mining equipment).

C. Such a policy would be opposed by powerful defense interests and carry political risks. In any case, given the tremendous size of Soviet military procurement--more than 1 1/2 times the size of US procurement in recent years--even freezing growth rate would have little impact on the character of deployed forces.

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D. Soviets could choose to accelerate defense spending ~~about~~ above 4-5% rate because of what they view as deterioration in international climate.

-- Such changes would most likely involve additional weapons development programs as well as greater investment in defense industries for greater production capacity in mid-to late 1980s.

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Relationships Among Soviet Defense and Civilian Industries

Defense Industry	Principal Civilian Lines at Final Assembly Plants	Other Closely Related Civilian Production Technologies
Ballistic missiles	Metal consumer goods, machine tools [a]	None
Aerodynamic missiles	Metal consumer goods, excavating equipment [b]	None
Fixed-wing combat aircraft	Metal consumer goods, parts for agricultural machinery	None
Fixed-wing support aircraft	Civilian transport aircraft, metal consumer goods, hand tools	None
Helicopters	Civilian rotary-wing aircraft, metal consumer goods	None
Naval surface ships	Merchant and fishing ships, chemical storage tanks, parts for transportation and agricultural machinery	Pumps, machine tools, mining equipment
Submarines	Merchant ships, oil pipelines, parts for transportation and agricultural machinery	Pumps, machine tools, mining equipment
Tanks	Railroad rolling stock and locomotives	Construction and transportation equipment
Other armored vehicles	Agricultural machinery	Construction and transportation equipment
Artillery	Agricultural machinery, motors, and machine tools	Construction and transportation equipment

[a] One ballistic missile plant produces civilian machine tools.
[b] One surface-to-air missile plant produces excavating equipment.

This table is Secret.

-- would hit civilian economy hard

-- consumer durables, services and housing likely areas for cutbacks

-- could have severe impact on labor productivity prospects